

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FRANCESCO LOMBARD	:	DETERMINATION
D/B/A PHIL'S PIZZA	:	
	:	
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1984	:	
through August 31, 1987.	:	

Petitioner, Francesco Lombard d/b/a Phil's Pizza, 75-63 31st Avenue, Jackson Heights, New York 11370, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1984 through August 31, 1987 (File No. 806622).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 24, 1990 at 2:00 P.M., with all briefs and additional evidence to be submitted by October 10, 1990. Petitioner appeared by Meyer Zimmerman, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

ISSUES

I. Whether the sales tax field audit of petitioner's business was reasonably calculated to reflect sales tax due.

II. Whether petitioner has established that either the audit methodology or tax assessed was erroneous.

FINDINGS OF FACT

The Division of Taxation ("Division") issued to petitioner, Francesco Lombard d/b/a Phil's Pizza, two notices of determination and demands for payment of sales and use taxes due, dated December 10, 1987. The first notice assessed sales taxes for the period September 1,

1984 through August 31, 1987 in the amount of \$99,750.60 plus penalty and interest. The second notice assessed a penalty of \$7,705.52 for the period June 1, 1985 through August 31, 1987.

The issuance of the notices followed a sales tax field audit of petitioner's business operations and records. The audit began on or about May 27, 1987, when the Division first contacted petitioner to schedule an appointment. Petitioner placed the Division in contact with his accountant, Meyer Zimmerman.

On June 17, 1987, an auditor spoke with Mr. Zimmerman by telephone and reviewed with him the records which would be needed for audit, including: a power of attorney; a general ledger for the period, September 1, 1984 through May 31, 1987; a cash receipts journal for the audit period; a cash disbursements journal for the audit period; Federal income tax returns and sales tax returns for the audit period; merchandise and expense purchase invoices for the period December 1, 1985 through May 31, 1986; sales invoices, guest checks and cash register tapes for the audit period; monthly bank statements; and a daybook for the audit period. During the conversation, Mr. Zimmerman informed the auditor that petitioner was in the process of selling his business and expected to close in the near future. He also stated that he would be on vacation and could not meet with the auditor until the end of July. Following this conversation, the auditor sent to Mr. Zimmerman an audit appointment letter, requesting books and records for the period September 1, 1984 through May 31, 1987 but not scheduling an audit appointment.

On June 22, 1987, the Division conducted an observation test of petitioner's business. An auditor was on the premises from 10:30 A.M. until 9:50 P.M. An auditor noted that petitioner used a cash register without a register tape and had no guest checks. An auditor counted the number of tables and chairs and made note of the general set up of the business. The restaurant menu stated that business hours were 11:00 A.M. to 11:00 P.M., but on the date of the observation, the business was closed by 10:00 P.M. The auditors maintained a list of all menu items sold and applied menu prices to each item. The items sold included pizza (whole

and by the slice), calzones, hero sandwiches, Italian ices, antipasto and soda (by the cup and in bottles). Petitioner also offered for sale hot plates such as spaghetti with meatballs and lasagna. By the end of the day, the Division calculated gross sales of \$871.48. The observation test was conducted before petitioner's books and records were reviewed because the Division was informed that the business was about to be sold, and the business's records might not be available until after the sale occurred. At the time of the observation, the Division had reached no conclusion as to the adequacy of petitioner's books and records.

The auditor met with Mr. Zimmerman on August 7, 1987. At that appointment, Mr. Zimmerman supplied the following records: daysheets for 1985; Federal income tax returns for 1984 and 1985; a cash disbursements journal for 1985; and bank deposit records for 1985 and 1986. The auditor left Mr. Zimmerman a list of additional information which would be needed at the next appointment, including: a power of attorney; daysheets for the periods September 1, 1984 through December 31, 1984 and January 1, 1986 through the date of sale of petitioner's business; the contract of sale and closing statement; proof that sales tax had been collected and paid on the bulk sale of fixtures and equipment; bank statements for the periods September 11, 1984 through March 11, 1986 and March 11, 1987 to the then current time; a 1986 Federal income tax return; purchase invoices for 1986; and a cash disbursements journal for 1987.

Some of the requested records were supplied at the next meeting held on October 1, 1987. Records required for audit and not supplied included: sales invoices, cash register tapes or guest checks for the entire period of audit; a general ledger; day sheets for the periods September 1, 1984 through December 31, 1984 and January 1, 1986 through the end of the audit period (quarterly sales sheets for the period June 1, 1987 through August 31, 1987 were provided); and a cash disbursements journal for the period January 1, 1987 through the end of the audit period.

The Division obtained information regarding petitioner's purchases for the quarter ended February 28, 1986 from one of petitioner's suppliers, C & F Dairy Co. The auditor was supplied

with a schedule showing a date, an invoice number, the total invoice amount, and the quantity and dollar amount of purchases in three categories: mozzarella, flour and pizza boxes. The schedule states that the invoices included other miscellaneous items, and in fact, invoices offered in evidence by petitioner show purchases by petitioner of fruit punch, cold cuts, pasta, cooking oil and other items.

The auditor's analysis of petitioner's cash disbursements journal, for the periods for which it was available, showed that checks were written to only one supplier, C & F Dairy. The cash disbursements journal for the period ended February 28, 1986 had no entry corresponding to one of the invoices listed on the schedule of information provided by C & F Dairy. That invoice showed a purchase of 2,000 pounds of flour, approximately one-third of the total amount of flour purchased for the quarter. The auditor's review of petitioner's daily sheets for 1985 showed cash purchases of soda and other unidentified items which were not otherwise recorded in ledgers or journals. Daily sheets were available only for 1985. Based on these findings, the Division determined that petitioner's records of purchases were too unreliable to support a markup test.¹

At the October 1 audit meeting, the auditor informed Mr. Zimmerman of the Division's intention to use the results of the observation test to determine tax due for the audit period. Mr. Zimmerman objected to this and requested that a markup test be employed, similar to one used by the Division on a prior audit. The Division declined to do a markup test, primarily on the ground that petitioner's records of purchases were incomplete.

To address petitioner's objection to the results of the one-day observation test, the

¹The auditor testified that she assumed that C & F Dairy sold only flour, mozzarella and pizza boxes as indicated on the schedule supplied to her. Based on this assumption, she concluded that, since petitioner's cash disbursements journal showed checks written only to C & F Dairy, he must have had unrecorded cash purchases from other suppliers. The auditor was not provided with the actual C & F invoices during the audit. C & F invoices submitted into evidence at the hearing show purchases of a wide array of food items from C & F, plus syrups used to make beverages and a small amount of soda. Therefore, the auditor's assumption was incorrect. However, the auditor's conclusion that there were cash payouts for soda and other items is supported by her analysis of the daily sheets for 1985.

Division attempted a second observation test on October 2, 1987. By this time petitioner's business had been sold. The new owner would not cooperate with the auditor. Although he allowed the auditor on the premises, he thwarted her attempt to record sales by blocking her line of sight and insisting that she sit at a distance from the food counter. This observation test was abandoned after several hours.

Because of the inadequacy of petitioner's records, the Division decided to estimate tax due on the basis of the June 22nd observation test.

(a) The observation test was conducted on a Monday. Daysheets were not provided for June 1987, but they were available for June 1985. Since reported gross sales for the quarter ended August 31, 1985 were comparable to those reported for the quarter ended August 31, 1987 (\$30,559.00 and \$30,450.00, respectively), it was deemed reasonable to make a comparison using figures taken from the 1985 records. The 1985 daysheets showed average taxable sales on Mondays in June to be \$202.31. Petitioner's taxable sales per the observation test were \$871.48. Using these figures, the auditor calculated a margin of error of 3.3076.

(b) The margin of error was applied to reported taxable sales for the period September 1, 1984 through August 31, 1987 to calculate additional taxable sales of \$1,166,024.92 with a tax due on that amount of \$94,555.40. Information regarding tax reported for the last two sales tax quarters was obtained from petitioner, but the information could not be verified by the auditor. In addition to tax assessed on additional taxable sales, the Division assessed sales tax in the amount of \$2,759.20 for the quarter ended May 31, 1987 and \$2,436.00 for the quarter ended August 31, 1987, representing taxes which petitioner claimed to have paid which could not be verified by the auditor.

(c) The Division assessed a penalty based upon petitioner's failure to accurately report and pay over all sales tax when due. An additional penalty was assessed for the period June 1, 1985 through the end of the audit period because the amount of the omitted tax exceeded 25 percent of the tax required to be reported.

Following the administrative hearing, the Division conceded that petitioner paid sales taxes for the last two quarters of the audit period as he had claimed. Therefore, the amount of tax in dispute is conceded by the Division to be \$94,555.40, rather than the amount assessed by the notice of determination.

As a check against the observation test, the Division estimated petitioner's sales for the audit period based upon the selling price of the business. The sale of petitioner's business was reported to the Division by the filing of a notification of sale showing a purchase price of \$250,000.00. A published study conducted by Robert Morris Associates provided a ratio of gross annual sales to total assets of 2.1. Utilizing this ratio as a basis for its calculations, the Division determined additional taxable sales for the audit period of \$1,222,464.81. The Division believed that this method of estimating tax generally confirmed the results of the observation test.

The Division attempted to reconcile petitioner's bank deposits, reported Federal gross receipts, reported taxable sales, and sales shown on his daily sheets, but it was unable to do so. In 1985, petitioner had bank deposits of \$142,100.50, reported Federal gross receipts of \$127,807.00, reported taxable sales of \$117,697.00, and sales on his day sheets of \$128,130.00. Petitioner never offered an explanation for the discrepancies. Furthermore, petitioner's records showed that employees were paid in cash, as were some of his suppliers, indicating that bank deposits did not necessarily include all gross receipts. Similar discrepancies were found for 1986, although daysheets were not available for that year.

At hearing, petitioner continued to assert that a markup test would have yielded a more accurate determination of sales tax due. Furthermore, petitioner challenged the auditor's contention that a markup test could not be performed because adequate purchase records were not available.

The Division had conducted an audit of petitioner for the period June 1, 1981 through August 31, 1984. As a part of that audit, the Division conducted an observation test on a Friday afternoon, from 11:00 A.M. to 4:00 P.M. Sales in this period amounted to \$317.00; however, it

appears from the documents submitted that only menu items made with flour (pizzas and calzones) were counted. Based on the five-hour test, the Division and petitioner agreed that total gross receipts for the day amounted to approximately \$650.00; however, this figure was not used to calculate petitioner's tax liability.

The Division's records show that two notices of determination were issued to petitioner for the period June 1, 1981 through August 31, 1984. On audit, the Division initially determined that petitioner's own records understated purchases by 53.2 percent. To estimate petitioner's taxable sales, the Division initially increased petitioner's purchases per books by 53.2 percent and applied a markup on purchases of 432% which was calculated from petitioner's Federal income tax returns. These calculations resulted in additional tax due of \$12,157.28. When these calculations were reviewed for accuracy, it was discovered that the auditor had made an arithmetic error, and the actual understatement of purchases was approximately 113 percent. This led to the issuance of a second notice of determination for the same period in the amount of \$11,405.56.

Petitioner offered in evidence a Statement of Proposed Audit Adjustment for the periods covered by the prior audit showing a total tax due of \$12,157.28 plus penalty and interest. This form provides a space where the taxpayer may consent to the audit findings by signing a statement to that effect. The document introduced into evidence by petitioner is unsigned.

In the course of the audit for the period June 1, 1981 through August 31, 1984, the auditor recorded the amount of flour used to make each of several menu items (whole pizzas, slices, etc.). This information was provided by petitioner. It is not known whether this information was used by the Division and, if it was, it is not known how it was used.

Petitioner's representative estimated petitioner's sales for the audit period at issue by applying the markup of 432%, taken from the prior audit, to petitioner's purchases as reported on his Federal returns. This resulted in gross sales of \$491,685.00. Petitioner reported taxable sales for the audit period of \$352,529.00.

Petitioner's representative also made a rough calculation of petitioner's flour purchases

for the audit period, using purchase invoices from C & F Dairy. He testified that four invoices were missing for 1986 and a substantial number were missing for 1985; therefore, he estimated the flour purchases based upon the invoices he had.

SUMMARY OF PETITIONER'S POSITION

Petitioner continues to maintain that the Division should have used a test period markup test to determine tax due. Petitioner disputes the Division's assertion that his purchase records were inadequate to verify purchases for the audit period. He asserts that on the prior audit note was taken of the amount of flour used to make certain menu items and that this information might have been used as a basis for a markup test on the audit in issue.

Petitioner asserts that the results of the observation test conducted on the prior audit establishes that the Division overestimated tax due for the periods in issue. He points out that the observation test conducted in 1985 was held on a Friday, traditionally a busy day in the pizza business, and resulted in taxable sales of only \$650.00. Petitioner argued that the Division's failure to make an adjustment for seasonal fluctuations in sales and its use of a Monday observation contributed to an overstatement of tax due.

It is petitioner's position that the Division's assertion of additional sales of over \$1,000,000.00 is contradicted by petitioner's bank deposit records which do not substantially exceed his reported sales

CONCLUSIONS OF LAW

A. Every person required to collect tax must maintain records sufficient to verify all transactions, in a manner suitable to determine the correct amount of tax due (Tax Law § 1135[a]; 20 NYCRR 533.2[a]). Among the records required to be maintained are "records of every sale" and the tax due on that sale (Tax Law § 1135[a]; see, Matter of Goldner v. State Tax Commn., 70 AD2d 978, 418 NYS2d 477, lv denied 48 NY2d 608, 423 NYS2d 1025).

Petitioner maintained no records of individual sales, such as cash register tapes or guest checks. In fact, petitioner does not even claim that he maintained verifiable records of sales. Where such records do not exist, the Division is required select an audit method reasonably

calculated to determine the sales tax due (Tax Law § 1138[a][1]; see, Matter of W. T. Grant Co. v. Joseph, 2 NY2d 196, 206, 159 NYS2d 150, 157). The burden is then placed upon the petitioner to prove by clear and convincing evidence that the audit method or the amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 859, 446 NYS2d 451, 453).

B. In essence, petitioner's position is that the one-day observation test was not a reasonable method of determining tax due. Petitioner further argues that a markup test would have been a preferable method of estimating tax. In support of this position, petitioner offers evidence of a prior audit and the results of his own purchase markup.

A one-day observation test is obviously not designed to bring about a precise determination of tax due, but precision is not required from an audit methodology where the taxpayer's own failure to maintain adequate books and records prevents exactness in calculating the tax liability (see, Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, lv denied 44 NY2d 645, 406 NYS2d 1025). Furthermore, such a methodology has been found reasonable where the taxpayer's records are undeniably inadequate to form the basis of an audit (see, Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679; Matter of Mera Delicatessen, Tax Appeals Tribunal, November 2, 1989; Matter of Gaetano Vendra, Tax Appeals Tribunal, February 9, 1989).

The record here supports the Division's conclusion that petitioner's records were so insufficient that an observation test was virtually the only means available to the Division to estimate tax due. Petitioner's only record of purchases was his cash disbursements journal which showed checks written to only one vendor, C & F Dairy. The daily sheets for 1985 showed cash purchases of soda and other unidentified items, but petitioner had no other record of these purchases and no daily sheets for large portions of the audit period. The Division's reconciliation of petitioner's cash disbursements journal with C & F Dairy purchase invoices for a test quarter found that petitioner had no record of a major purchase. No purchase invoices were provided to the auditor. In his testimony, petitioner's representative stated that not all C &

F invoices were available to him, and that he had to estimate petitioner's flour purchases for the audit period. Under these circumstances, the Division properly concluded that petitioner's records would not support a test period markup audit. Moreover, even if the C & F Dairy invoices provided sufficient information to enable the Division to perform a reasonable markup test on some menu items, notably those made with flour such as pizza and calzones, they were not sufficient to allow the Division to determine tax due on all menu items, e.g., soda in cans and bottles, hero sandwiches, antipastos, etc.

It is apparent that the audit preceding this one used a different methodology to arrive at an assessment of tax due. However, this fact merely establishes that in the absence of verifiable books and records several reasonable audit methodologies are possible, none of which will result in an exact determination of tax due. It is worth noting that petitioner's purchase records were found to be wholly inaccurate on the first audit, as well as the audit at issue here. In light of the fact that petitioner's business was audited on a previous occasion, he should have been aware of his obligation to maintain records of individual sales. In the absence of such records, it cannot be said that the observation test was an unreasonable method of determining tax due, and the records submitted by petitioner do not establish that the method used resulted in an overstatement of the tax owed (see, Matter of A & J Gifts Shop v. Chu, 145 AD2d 877, 536 NYS2d 209, lv denied 74 NY2d 603, 542 NYS2d 518).

C. The petition of Francesco Lombard d/b/a Phil's Pizza is denied in all respects, and the notices of determination dated December 10, 1987 are sustained as modified by Finding of Fact "12".

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE